REGIONAL AUSTRALIAN WATER INFRASTRUCTURE

TAXATION AND NSW IRRIGATION CORPORATIONS

Introduction

We are one of a number of collective irrigation businesses who have either moved to full taxpayer status through transfer of the business to local ownership, or who will face Tax Equivalents Regimes which mimic that status.

The entities operate so as not to make a profit in excess of funds needed for operation and infrastructure consumption, that is, a cost recovery approach akin to co-operative ventures, and to smooth that level of revenue over the years.

Ownership of this former NSW Government owned and operated irrigation scheme was handed over to a local irrigator Company on 12 February 1999, in accordance with the national water reform agenda, and in respect of management control, the ultimate step in accordance with the 1995 COAG principles.

The infrastructure we have custody of is clearly community infrastructure, and other members of the community have a free ride in that they do not directly fund its upkeep. The road bridges and culverts over our channels especially support the wider community, and tourism is especially dependent on their renewal. We hold the assets in trust for future generations. We need special tax treatment for this infrastructure.

We believe that current provisions of the Income Tax Assessment Act do not adequately address the taxation problems caused by the COAG national water industry reform process. These problems were recognised by expert groups working with COAG, who noted the need for government to address tax policy issues to facilitate the reform. In our view, although the need was recognised, it was not followed through or put in place. The irrigation entities have historically been owned by State government and, with the State government taxation exemption, there has not been cause to consider the tax policy issues relating to these entities.

The assets of the businesses were taken over on the basis that NSW Government would contribute over a number of years to redress accumulated run down in the condition of the assets. This partly recognises that so called “past subsidies to operations” have gone to inefficient NSW Departments who used to own and run the schemes, and in some other schemes, still do. Irrigators are also to contribute to present needs and to accept responsibility for funding the future needs for works and reserves.

Perspective

- If the infrastructure had been renovated or replaced over the last few years with either Government or irrigators funds, then there would not have been the need for the NSW Government grant now, and the additional value in the assets would have been available to the company to base tax depreciation on, which would have offset future infrastructure annuity raisings.

- If the money needed for infrastructure had been retained within the business over the last few years, then there would be no need for further Government grants, and the accumulated money could have come over as an asset of the new Company at rule the books date. Additional value in the assets as a result of doing the renovation or replacement work over the next few years, would have been available to the company to base tax depreciation on, again as an offset for the future infrastructure annuity raisings.

- If the infrastructure system was not so old, there would be sufficient remaining value in the assets to establish tax losses as a result of depreciation, to offset against taxation on future raisings of capital in the way of infrastructure annuities.

In our case;

- The Company's assets are almost at the end of their life, and the Company needs to raise capital from both NSW Government and the irrigators, to renovate and replace it, and

- This situation with infrastructure investments is compounded by the national water reforms, which are calling for the introduction of land and water management plans to ensure future sustainability, and through growth in environmental flow requirements which have reduced water available to irrigators, and

- Both areas call for water efficiency gains, and the only way to offset the loss of water and meet demands for increased production is through investment in water saving technology. The company and its peers face calls for enormous investments in these areas, and

- As we do that, the ATO position is that tax must be assessed on those amounts raised by way of Government grants, and on funds raised from irrigators.

This is even more concerning, as it seems that the tax regime results in investments in replacement of older less efficient water systems having a tax preferential treatment for our Company, over similar investments in new more water efficient works. For us, if we replace the not so efficient earth channel systems that were put there 80 years ago we are better placed from a tax perspective than if we put in new more efficient piped works.

The Company and its community needs to and wishes to carefully sustain the infrastructure, and invest in water efficiency savings, and we are left with;

> ***A low level of initial tax depreciation on the existing infrastructure, due to its age,***
> ***A need to make hundreds of millions of dollars of investments in the name of water efficiency,***
> ***Commitment from the State and irrigators to provide funds, and***
> ***The ATO demanding tax on the contributions.***

In respect of Natural Resource Management and Rural and Regional Infrastructure policies of the Federal Government, this is counter productive.

Background

The potential for just this situation was clearly seen by the COAG Working Group on Water Reform. In its first report the group noted that for the reform of the water industry to be effective, the tax implications that were foreseen, should be examined by a sub-committee**. They suggested that it may need taxation reform.**

In their second report they noted that advice from the ATO in February, 1995, had assisted in clarifying the position of the corporatised schemes, enabling the progression of the reforms. This 1995 ATO advice suggested that Government contributions in the form of capital grants to Companies for deferred infrastructure renovation or replacement, would be assessable as income, but there was the potential for a genuine agency relationship to be formed which may have resulted in the grants not being assessable. It also suggested, if that were the case, that depreciation on the assets constructed with the grants would not be available as allowable deductions. This agency relationship is incredibly difficult to put in place and defend, given the requirements of Corporation Law.

At its meeting in February 1994, COAG agreed that an Expert Group should report to it on asset valuation and cost recovery for water and water services. The COAG Working Group commissioned the Expert Group, and in its report of February 1995, that group reported that;

> "It is accepted for long life assets in the water industry…that the replacement cost approach to asset valuation and associated depreciation is the preferred approach…It is equally clear that for taxation accounting, as the income tax law currently stands, that a replacement cost approach is not acceptable. The Expert Group does, however, note the apparent incompatibility especially in the medium to longer term, of taxation arrangements which determine profit subject to tax on the basis of historic cost approaches to depreciation, and charging…based on sustainable service delivery capacity."

They go on to say that;

> **"It is not difficult to envisage a situation where… revenue needed to provide for eventual replacement of assets will be treated as profits from the view of taxation and taxed…The Expert group is of the view that this matter be considered by those responsible for …tax equivalent regimes with the aim of facilitating…without undue loss of funds to taxation."**

This later comment on the State Tax Equivalent Regimes overlooks the requirement that those regimes need to mimic the Federal taxation regimes or, under Competition Policy, States will have payments withheld.

In its 1997 study, the consultants (Ernst & Young), when dealing with the Water Industry Asset Valuation Study for the Standing Committee on Agricultural Resource Management (SCARM), noted a number of taxation issues that would adversely affect the implementation of reforms in the industry.

In their papers **they recommend specific legislation** to address a number of issues, including classification of deductible items, the deeming of entities as primary producers or providing similar benefit, taxation treatment of contributed assets, definitional issues in repair and maintenance, as well as the lack of tax depreciation shelter for entities with significant need for funds for renovation and renewal of infrastructure. Inevitably however this group were also relying on the former ATO ruling on non assessability of grants. In doing so they recognise that even the former ruling "**does not appear to deal with the problems relating to lack of tax depreciation shelter for funds gathered for replacement works."**

The report suggested that COAG could recommend a new division of the ITAA specifically for the water industry.

We now seek government support for proposals to provide specific remedies for the taxation timing difficulties faced by these entities. Those proposals cover five areas;

The Proposal Areas

A. Immediate Funding Needs – The Competition Issue

Because of the special needs of the older schemes for up front funding from Government and irrigators, tax timing imbalances put the relative competitive position of the customers of the schemes at disadvantage.

The entities themselves also face tax treatment which competitively disadvantages them in the introduction of new technology infrastructure to the business. This is contrary to sound environmental best practice and is not what the entities or the community wants.

For comparison;

A single farm with a river pump is a primary producer and accelerated write off on water facilities 387-B applies.

Large Corporate Farming Schemes in public company ownership, enjoy at least similar tax arrangements to single farms with river pumps.

Private Irrigation Districts in N.S.W., are collective statutory corporations, constituted around the primary production landholdings their channel networks provide water supply services to. They are exempt from Federal Income and Sales Tax provisions, and are not subject to State Tax Equivalent Regimes.

Murrumbidgee Irrigation Limited If one person or corporation owned all the farms and the channel system in our company scheme as a conglomerate, they would receive accelerated depreciation on water facilities.

The company is treated differently, even though it is;

- Captively owned by the irrigators,
- not permitted to pay the owners a dividend,
- not permitted to return company capital to the owners, even on windup,
- operated to cover costs of operation, maintenance and future renewal of assets, and not to earn a profit,

The other older schemes have similar needs and face similar competition and tax timing problems.

Suggested Outcomes

The schemes face additional taxation that competitors do not, which must be passed on in water charges.

The agricultural production of shareholders and customers is artificially made less price competitive in local and international markets. It also makes members uncompetitive on water transfer markets.

This is inconsistent with competition principles, inconsistent with fair treatment, and would fail the public interest test. It is totally at odds with the Commonwealth's expressed commitment to competitive neutrality.

It can be readily put right by either;

- extending the classification of primary production to the company and similar collective irrigation enterprises, or

- inserting specific definitions of "collective irrigation corporations" and "collective irrigation businesses" into the ITAA to give effect to similar accelerated tax write off of capital investment in water and drainage facilities.

The second alternative is less likely to lead to flow on claims from other businesses who also deal with primary producers. It can also restrict the concession to "collective irrigation businesses", with captive ownership which is different from other suppliers who service our customers (fertilisers, fuel etc).

It may also avoid any other unnecessary tax implications which might arise for the irrigation collectives from being deemed to be primary producers.

B. Longer Term Funding Needs – The Matching Issue

The key financial requirement of these entities is the recovery of sufficient funds from irrigators by way of annual levies to provide water to the irrigators (operating levies). This encompasses an obligation to collect funds periodically to allow for the establishment of a sinking fund to be used for later infrastructure renewal and replacement.

Funds are paid by irrigators pursuant to annuity fund levies and are quarantined by the irrigation entities from other operating accounts so that the funds are only used as required for infrastructure replacement or renewal. Investment of the funds follows very conservative investment criteria aimed to protect the capital base. In some cases, funds may also be provided by State and Federal government or other stakeholders (such as local councils) in order to promote and sustain the irrigation infrastructure and its dependent community.

From the perspective of the agricultural sector, the prudence of establishing a sinking fund for infrastructure is beyond question. This industry is highly capital intensive, with works programs on channels, drainage basins and environmental protection/enhancement requiring substantial funds.

The projects arise in cycles extending to 50 years and beyond and can involve tens of millions of dollars. If these works were to be funded by farmers (as the main contributors to the irrigation entities) when needed, the level of funding required per farmer would not be able to be secured. The annuity fund levies seek to spread the funding so that farmers are able to better accommodate the cash flow requirements of this unique sector of the economy.

It should be noted that, even with existing tax arrangements, when the funds are ultimately expended by the irrigation entities on capital programs, tax deductions are available pursuant to the depreciation or other specific deductions in the tax legislation.

The issue is that the tax laws create a timing disadvantage and deplete the ability of the entities to accumulate needed funds. The entities would be prepared to forgo tax deductions on the capital works in return for tax exemption on the funding used to conduct the works, so as not to seek to gain.

Suggested Outcomes

One alternative is a rural infrastructure fund. Under this proposal, the tax laws would be amended to provide for funds to be accumulated free of tax (upon their receipt) provided certain criteria were met:

i) the funds must only be accumulated for prescribed purposes, being rural infrastructure renewal or similar primary production purposes (dams, environmental enhancements in agriculture, civil works relating to certain farmlands etc). The government can carefully control the range of prescribed activities in order limit the use (and prevent the abuse) of such provisions;

ii) the funds must be received by irrigation entities or other entities acting at the direction of such entities. The funds can thereby be earmarked for specific region/irrigation districts and the level of funds collected must be commensurate with the capital project needs of the area;

iii) deductions would continue to be available to irrigators for the payment of funds into the Rural Infrastructure Fund (RIF) (as is presently the case). However the funds would not be assessable to the RIF. The RIF may be established as a discrete entity (such as trust or company) or a discrete account maintained by the irrigation entities themselves;

iv) when funds were withdrawn from the RIF and used for capital works, the cost of the works could not be claimed as a deduction by the irrigation entity. This measure ensures that there is no tax advantage in using the RIF other than the removal of the timing leakage discussed above.

   We recognise that this timing disadvantage may occur in many other circumstances and for many other taxpayers.

   The unique feature of irrigation entities is that their businesses are conducted as cost recovery only and there is no ability for a tax disadvantage in one area to be offset by tax losses or deductions in other areas. This is particularly the case with a infrastructure fund levy which has the sole aim of collection and retention of funds to allow future infrastructure renewal and replacement works to occur.

   Similar “quarantine” arrangements to that outlined for part A of this proposal, could and probably should be applied.

C. Specific Concession for Expenditure on Water Facilities

A second and complementary initiative is the extension of a specific tax concession currently provided under the tax regime to expenditure on water facilities of the irrigation entities.

Division 387B of the Income Tax Assessment Act 1997 (“ITAA97”) allows specific deductions for primary producers who incur capital expenditure on water facilities. These deductions apply on a three-year straight line basis to capital expenditure incurred by primary producers on land in Australia on the construction, acquisition or installation of plant or a structural improvement for the purpose of conserving or conveying water for use in carrying on that business. If the concession is available to the irrigation corporations, they will effectively be entitled to claim higher write-off of plant and equipment going forward.

The definition of “primary production business” in ITAA97 does not however cover irrigation entities. Accordingly, as it presently stands, the specific concession above is not available to these entities.

Suggested Outcomes

Based on the above, we have considered some potential amendments to the above provision. We recommend that specific definitions of "collective irrigation corporations" and "collective irrigation businesses" be inserted into the ITAA to make available the specific concession to the irrigation entities. Such an amendment would be preferable to extending the definition of "primary production business" to include the irrigation entities as it would avoid any unnecessary tax implications which might result form such an extension. Further, the separate definition would also allow the government to restrict the grant of the concession to such entities, eliminating any potential 'floodgate' problem.

Assuming the above amendments are enacted and the specific concession is made available to the irrigation entities, we would also recommend the inclusion of "bridges", "culverts" and "drainage control" within the definition of "water facility" in Division 387B. This will ensure that the concession applies to all the water infrastructure assets of the irrigation entities.

This proposal, if adopted, still exposes the irrigation entities to some timing disadvantage discussed above. However, the deduction for capital expenditure is accelerated (one-third of the expenditure being deducted in the year in which it is incurred and a further third in each of the next two years), hence minimising such a disadvantage.

In addition, if a particular irrigation entity has a long lead time between receiving the funds from irrigators and incurring the expenditure on the works, then they have the alternative (discussed above) to use a rural infrastructure fund and thereby overcome the timing problem.

D. Specific Concession for Capital Expenditure on Landcare Operations

A third complementary initiative is the specific tax concession currently provided under the tax regime to expenditure on landcare operations.

Division 387A of the Income Tax Assessment Act 1997 ("ITAA97") allows specific deductions for businesses who incur capital expenditure primarily and principally for certain landcare operations purposes. These deductions apply on an immediate deduction basis. If that concession were available to the irrigation corporations, in respect of the massive works needed to protect the land and water environment in the irrigation areas, to combat salinity in lands used for irrigation and in river flows, and to dramatically reduce accessions to groundwater, they will effectively be entitled to claim immediate write-off of the necessary investments in infrastructure.

There is some suggestion that the range of works involved may not be seen as qualifying. If that were to persist, the specific concession may not be available to these entities.

Suggested Outcomes

We consider it essential that the federal Government is able to deliver on its policy objectives of reform in the national water industry and in promoting investments in works that will arrest existing environmental degradation, and create the water efficiency savings needed to enable a fairer sharing between the competing uses.

To achieve this it is essential that there is clarity in the range of investments that qualify for the landcare operations deduction.

E. Future Provisions

Each of the major NSW irrigation collectives has recognised the inherent variability in water access available and either has, or is putting in place, schemes to buffer irrigators against dramatic input cost shifts for water between years of plentiful supply and years of shortage.

There are a variety of ways to do this, but basically it encompasses collecting a little extra revenue in times when irrigators have capacity to pay and using that later when, through low levels of water availability, there is less capacity to pay.

This is consistent with Farm Management Deposits (FMD's) used by industrial primary producers.

Suggested Outcomes

It is suggested that some similar arrangement could be available to the collectives, which would provide a matching of company income with expenditure and support the prudential provisions which are inherent in the Government's existing policy on FMD's, at a regional level.